

ISSUES WITH RESPECT TO FORCED COMBINATIONS

Revenue Laws Study Committee

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Overview

- ▣ Directive
- ▣ Effective Date
- ▣ Fiscal Impact



Directive

- ▣ Directive #CD-11-01
- ▣ Expected to be issued in early November
- ▣ Explains the Department's current practice with respect to Secretary's authority under various law to require a corporation to file a combined return
- ▣ Explains the Secretary's authority under new law to redetermine a corporation's net income by adjusting intercompany transactions or requiring the filing of a combined return

Directive – Current Law

- ▣ Conditions for a Combined Return
 - Common ownership or control
 - ▣ Common ownership or control of more than 50% of voting stock
 - ▣ Control or ownership may be direct or indirect
 - Unitary business
 - ▣ Unity of ownership, operation, and use
 - ▣ Can also exist in interdependence of functions
 - Net income properly attributable to the State not disclosed
 - ▣ Intercompany transactions in excess of cost
 - ▣ Intercompany transactions that shift an income producing asset
 - ▣ May include companies utilizing options under 105-130.7A or 105-130.12

Directive – Current Law

- ▣ Entities included in combined return
 - Only those entities in unitary business whose intercompany transactions cause net income not to be properly disclosed
 - May or may not be federal consolidated group
 - May or may not be all entities in unitary business
- ▣ Entities excluded from combined return
 - Corporation not required to file a federal return
 - An insurance company subject to tax under Article 8B
 - A corporation exempt from tax under section 501
 - An S Corporation
 - A partnership, LLC, or other entity not taxed as corporation

Directive – Current Law

▣ Methodology

- FTI of individual companies as computed on pro forma 1120s
- Combine the 1120s
- Eliminate intercompany transactions
- Make North Carolina modifications
- Determine apportionment factors
- Apply one apportionment formula
- Add nonapportionable income
- Reduce by net economic losses
- Reduce by tax credits

Directive – Current Law

▣ Process

- One company in the group (the principal member) files Form CD-405 and fills in “combined return” circle
- This return replaces separate entity income tax returns of all members of group
- Each member of group is jointly and severally liable for combined tax liability
- Each member of the group that is doing business in NC files a separate franchise tax return – the principal member files on the combined group’s CD-405, all other members on a separate CD-405
- Each member calculates its apportionment factor separately for franchise tax purposes
- Eligibility for tax credits is determined on a separate company basis

Directive – New Law

- ▣ Economic substance
- ▣ Fair market value
- ▣ Adjustments to income
- ▣ Combined returns
- ▣ Other authority and limitations
- ▣ Voluntary redeterminations



Directive – New Law

- ▣ Economic substance
 - Transactions, not entities, are evaluated for economic substance
 - Two-part test – both parts must be satisfied
 - ▣ One or more reasonable business purposes other than creation of tax benefits
 - ▣ Economic effects other than the creation of tax benefits
 - Taxpayer has burden of proving economic substance
 - Department will continue to rely on federal and state case law, where applicable and where not in conflict with G.S. 105-130.5A, to determine whether tests have been satisfied

Directive – New Law

- ▣ Economic Substance – Five General Principles
 - Economic substance is a prerequisite to any provision allowing deductions
 - Taxpayer that claims deduction bears burden of proving economic substance
 - Economic substance of a transaction will be viewed objectively rather than subjectively
 - It is transactions, not entities, that are examined
 - Arrangements that do not affect economic interests of third parties will receive close review

Directive – New Law

▣ Business Purpose

- Asserted business purpose must be valid and realistic
- Transaction must be a reasonable and realistic means to accomplish asserted purpose
- Evidence that the taxpayer took steps to achieve the asserted purpose
- Asserted purpose must be commensurate with the tax benefits claimed
- The asserted purpose must be supported by contemporaneous documentation

Directive – New Law

▣ Economic Effect

- Taxpayer must prove by objective evidence that a reasonable likelihood of non-tax economic benefit from the transaction existed at the time the transaction was initiated
- Taxpayer must prove by objective evidence that the transaction affected the taxpayer's financial position in a positive and meaningful way apart from tax benefits

Directive – New Law

▣ Specific rules

- Reasonable business purpose and economic effects include material benefit from a transaction
- Transactions consistent with legislative intent
- Centralized cash management not itself an indicator of lack of economic substance
- Achieving a financial accounting benefit is not a reasonable business purpose if the origin of the benefit is a reduction of State income tax
- For combinations only, economic effects test may be satisfied by showing material business activity

Directive – New Law

- ▣ Fair market value
 - Department will apply regulations adopted under section 482 of the Code
 - Department will apply any applicable case law
 - Production of a transfer pricing study alone is not sufficient to establish that transactions are at fair market value



Directive – New Law

- ▣ Adjustments to net income
 - If the taxpayer fails to establish transactions have economic substance and are at fair market value, the Department may redetermine net income
 - Adjustments include
 - ▣ Disallowing deduction in whole or in part
 - ▣ Attributing income to a related corporation
 - ▣ Disregarding transactions
 - ▣ Adjusting the apportionment factor
 - ▣ Reclassifying income as apportionable or allocable

Directive – New Law

- ▣ Combined returns
 - Option if adjustments are not adequate under the circumstances to redetermine net income
 - Unless an alternative is agreed to by the taxpayer, a combination must include all members of the unitary business
 - Secretary will issue a written notice to file a combined return of all members of the unitary business group – the corporation shall submit this information but may propose an alternative

Directive – New Law

- ▣ Combined returns
 - Entities excluded from combined return
 - ▣ A corporation not required to file a federal income tax return
 - ▣ Certain types of insurance companies
 - ▣ A corporation exempt from tax under section 501
 - ▣ An S corporation
 - ▣ A foreign corporation as defined in section 7701
 - ▣ A partnership, LLC, or other entity not taxed as a corporation
 - ▣ A corporation with at least 80% of its gross income being active foreign business income
 - Methodology and process the same as under current law

Directive – New Law

- ▣ Other authority
 - G.S. 105-130.5A provides that nothing in the new law limits or negates the Secretary's authority to make tax adjustments as otherwise permitted by law
- ▣ Limitations
 - The Secretary is not permitted to make adjustments that limit a corporation's options for reporting royalty payments under G.S. 105-130.7A; however, the Secretary may still adjust the amount of the payments if they are in excess of fair market value

Directive – New Law

- ▣ Voluntary redeterminations
 - Under H 619 as originally enacted, the Secretary's authority to allow a combination requested by a taxpayer absent a finding of transactions that lacked economic substance or were not at fair market value was questionable
 - S 580 clarified that the Secretary has the authority to allow a mutually agreeable combination if net income properly attributable to this State is not accurately reflected on a separate return without a finding that transactions lack economic substance or are not at fair market value

Effective Date

- ▣ Original effective date in H 619 resulted in a “gap period”
 - Old authority was repealed January 1, 2012
 - New authority did not become effective until taxable years beginning on or after January 1, 2012
- Therefore, uncertain if the Secretary had any authority to require a combined return after January 1, 2012 for any taxable year beginning before that date
- This was a further complicating factor that called into question the validity of existing agreements

Effective Date

- ▣ The General Assembly addressed this issue in S 580 by adjusting the repeal date for the old authority
 - The old standard applies for taxable years beginning before January 1, 2012
 - The new standard applies for taxable years beginning on or after January 1, 2012
- ▣ Bright-line test

Effective Date

- ▣ No gap period, the Secretary has some ability to force combinations during all time periods
- ▣ All taxpayers are treated equally for relevant time periods
- ▣ Certainty
 - Taxpayers and the State know exactly what standard will apply
 - No question of the applicability of the agreements entered under previous initiatives
- ▣ Potential for ongoing conflict under old standard

Effective Date

- ▣ Questions from a possible change of effective date
 - To whom would it apply?
 - Impact on current agreements?
 - Potential legal issues
 - ▣ Retroactive increase?
 - ▣ Exclusive emoluments?



Fiscal Impact – In General

- ▣ Still unknown as recurring impact from substantive law change
- ▣ Extremely difficult to estimate
 - Fact-intensive nature of the analysis
 - Impact on taxpayers who have settled?
 - Changes in behavior of other taxpayers?



Fiscal Impact – Effective Date Change

- ▣ Potential maximum immediate refunds from retroactive effective date - \$132.9M
 - Impact on existing taxpayers under settlement agreements - \$119.7M
 - \$6.6M from recently collected assessments not under appeal
 - \$6.6M from recently collected assessments under appeal
- ▣ Potential maximum future collections lost (amounts assessed but not yet collected) from retroactive effective date - \$225.8M
- ▣ No recurring impact from effective date change

Questions

